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DEDUCTION OF INTEREST ON LOANS ASSOCIATED WITH LIFE INSURANCE ANNUITY CONTRACTS

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SENTIMENTALISTS SOMETIMES BEMOAN the fact that chivalrous warfare has disappeared, having been replaced by total war and more recently by total annihilation. If civilized society has a need for conflicts managed by gentlemen, conducted within the bounds of propriety and eventuating in less than total destruction of one's opponent, the modern game of "taxmanship" goes a long way towards filling that need.

On one side of the battle line in the game of collecting and resisting taxes is arrayed a vast number of private soldiers known as taxpayers and their officer corps consisting of tax lawyers, tax accountants, other tax consultants of various ranks, editors of tax "poop sheets," legislative representatives, and a great miscellany of supporting staff men. This army is usually referred to by its partisans as "the public" or "the taxpayers."

On the other side of the battle line is a less populous army usually referred to broadly as "the government," sometimes narrowly as "the Treasury" or even more narrowly as "the Service." The government army while less populous has many advantages over the taxpayers. It has highly trained front line troops known as agents. These agents are not only trained in parachute and commando tactics, but under the rules of warfare decreed for the game, they have practically unlimited power to interrogate any enemy troops that they capture. The government's front line troops are supported by a well organized apparatus manned by attorneys, accountants, economists, statisticians, staff advisors and general utility officers known as "administrators."

The members of the tax writing committees of Congress and their staff assistants occupy a somewhat unique position in the game. Though the committee members periodically have their commissions renewed or terminated by the troops on the taxpayer side, they and their staffs are stationed on the government side of the lines. They frequently participate in meetings of the general staff of the government side. They stand somewhat in the position of representatives of the International

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Red Cross in that they investigate complaints from both sides with respect to charges of violations of the rules of humane warfare. In addition the committee members and their staffs sometimes play the roles of the ancient Greek and Roman gods merely observing with detachment the battles of mortals, but occasionally participating in battles to save a favorite mortal or to punish a combantant who had participated in a particularly heinous breach of the proprieties of warfare.

As in the case of any respectable war, the game of "taxmanship" is continually reported by a large corps of war correspondents. They range from reporters for the weekly supplemented tax services who concentrate on "just the facts" to the "columnists" who "sense trends" and "report in depth" and who alternatively attempt to "hot up" the battle by suggesting new weapons (or new uses for old weapons) or to secure an armistice by recommending terms to end the conflict.

The arrangement for compensating the bulk of the officers on the taxpayer side constitutes one of the greatest weaknesses of that side — and conversely one of the greatest strengths of the government side. Unlike the compensation system in effect for the officer corps of "developed" nations, the system for compensating the officer corps of the taxpayer side is bottomed on the proposition that an officer's pay should depend not only on his success on the battlefield, but more importantly, on how many privates are willing to follow him into battle. Since the privates are given a practically unlimited choice of officers to follow, the result is foregone — there is an incentive for the officers to demonstrate their superiority over the enemy and over each other. Most of the officers are bound by a strict code of honor which prevents them from deprecating fellow officers or openly soliciting a following. However, all of the officers are free to become part-time war correspondents. Their dispatches from the front may take the form of a glowing report on a particularly clever weapon the officer has just devised or a boastful release about the discovery of a gaping hole in the enemy's defensive line.

The honor code of some members of the taxpayer-officer corps does not prohibit open solicitation and it is not unknown for certain numbers of that segment of the corps to race through their own camps shouting for privates to follow them to a weak point in the enemy line. These battle cries are almost always heard on the enemy side of the line.

It takes no espionage effort on the part of the government's intelligence staff to discover the taxpayer's new weapons (even in the drawing-board stage), the likely route of the next taxpayer attack and the enemy's knowledge of the government's weak positions. All of that intelligence is readily available to the government's generals by simple and inexpensive expedients such as reading the daily newspapers (including the classified ads) and specialized journals devoted to tax subjects and accepting invitations to attend taxpayer briefing conferences.

The intelligence handed to them by the enemy is followed up by the government general staff in a number of ways. The general staff usually puts out a bulletin to all troops to be on the look out for the touted new weapon or attack in a particular sector and to report immediately any suspicious enemy maneuvers in the area. Next the staff advises the troops on the best method of countering the new weapon or repelling the attack in a weak sector. Frequently the intelligence is transmitted from the government's staff to the Congressional committees and their staffs with a request that the enemy's new weapon or tactic be declared a violation of the rules of humane warfare or conduct unbecoming a gentleman.

The purpose of this article is not to tell a war story or even to describe a battle. Rather it is the purpose of this article to describe a series of skirmishes and counter-skirmishes over a small part of the battle line. These skirmishes are in many ways typical of the many other skirmishes which are (and have been) occurring on other parts of the line and which, in total, are the battle which never seems to end.

A secondary purpose of this article is to set forth one part-time war correspondent's humble suggestions on how to stabilize the line at one particular point. This seems desirable if for no other reason than to permit the combatants at this sector to either withdraw from the battle entirely or at least concentrate on other areas of the war.

SECTION 215 OF THE REVENUE ACT OF 1964

Section 215 of the Revenue Act of 1964[1] is the latest maneuver in a long series of maneuvers which revolve around the problems created by the general deductibility of interest, under our income tax system, whether or not it is paid in connection with the earning of taxable income. The details of section 215 of the Revenue Act of 1964 will be set forth and discussed later in this article. In essence section 215 of the 1964 Act amended section 264 of the Internal Revenue Code of 1954[2] to provide that beginning in the year 1964 a taxpayer will not be entitled to deduct interest on: "indebtedness incurred or continued to purchase or carry life insurance, endowment or annuity contract . . . pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise)."

1. P.L. 88-272, 78 Stat. 19, 26 U.S.C. § 264.
2. 68 Stat. 3, 77.

Treasury Secretary Dillon in his statement to the Ways and Means Committee, supplementing President Kennedy's January 24, 1963 tax message, urged the enactment of provisions "to curb abuses under other devices to finance the purchase of insurance on the basis of tax deductions and tax-free income."[3] In the technical explanation which was submitted in connection with Secretary Dillon's statement, the problem and proposed solution were spelled out in more detail. The Treasury there stated:

> It is recommended that the interest deduction be denied in the case of interest on a loan incurred as part of a plan to purchase a life insurance contract through borrowing. Substantial tax abuse can occur when an individual uses borrowed money to pay the premiums on a life insurance, endowment, or annuity contract. This is because the interest on the loan is deductible for tax purposes, while the corresponding interest build-up on the reserve in the policy is not taxed currently.[4]

The Treasury statement went on to explain (complete with example) how taxpayers in relatively high income tax brackets can realize a "profit" by purchasing insurance, endowment or annuity contracts with borrowings which result in tax deductible interest. The Treasury mentioned the fact that one insurance company had advertised the tax profit potential associated with the deductible interest feature of a plan for purchasing retirement income contracts with borrowed funds. The example supplied by the Treasury purported to show that a taxpayer in the 60% income tax bracket could realize an annual profit of $12.50 for each $1,000 of borrowing at 3¾% interest to purchase a contract providing an annual increase in cash surrender value based upon a 2¾% interest rate. The Treasury reported that there was "on record an instance" involving a policy with a 3 million dollar annual premium. On the basis of such an annual premium, the Treasury said that in the tenth year "the profit from borrowing in such a case would be $375,000." It should be noted that the Treasury did not say that there was an "instance on record" of such a tenth-year profit being realized or even of a borrowing connected with such a king size contract — it merely cited an actual case of a $3 million premium and then assumed the result if the premiums on such a contract were financed on the basis of the interest expense and interest buildup on the reserve assumptions mentioned in the example.

The "profit" from borrowing shown in the Treasury's example ignored the fact that the interest element in the reserve buildup feature of an annuity contract is eventually includible in taxable income. This

3. House Document No. 43, 88th Cong., 1st Sess., Part 1, 29, 51 (1963).
4. *Id.* at 75 & 110.

"error" in the example was pointed out at subsequent hearings before the Ways and Means Committee.[5] It was there demonstrated that when the Treasury example was expanded to reflect the fact that the increase in cash value was subject to income tax, the Treasury's $12.50 "profit" became a *loss* of $4. Using the Treasury's method of computing "profit" in the $3 million annual premium case and interpolating the corrected figure (showing a loss), it can be shown that the taxpayer in this situation would have built up a potential loss of $120,000 after ten years of ownership of this jumbo policy. This hardly seems like an attractive prospect for any taxpayer whose effective tax rate is 100% or less. Absent a tax rate of over 100%, an out-of-pocket loss is not worthwhile, despite some popular beliefs to the contrary.

The basic fallacy in the Treasury's presentation of its horrible example lays in the fact that it attempted to demonstrate its point by reference to an annuity contract — viz., a type of contract where the taxation of the interest element in the reserve is deferred not eliminated. An example built around a life insurance contract in which the interest element in the reserve rarely is subjected to income tax would have been more meaningful. Admittedly, such an example would not have produced the same shock effect. It is difficult to imagine the situation wherein a purchaser of life insurance could borrow the entire cost of the first ten years' premiums solely on the security of the contract. Such was the assumption in the Treasury's example involving an annuity contract. It is possible to describe an annuity purchase plan involving a maximum borrowing at an interest rate in excess of the interest rate which is being earned on the investment and to argue that such a plan can result in a profit only by virtue of a tax deduction. However, the same argument loses its appeal when applied to a life insurance contract under which the insurance protection over and above the reserve value is an item of real and substantial economic worth, regardless of the difference in rates of interest paid and earned.

The point here is not to indicate that the Treasury misstated its case or that the congressional committees were misled into enacting section 215 of the 1964 Act. Rather, the point is to show that the Treasury in recommending the legislation and Congress in enacting it were principally concerned with striking back at what they perceived to be a trafficking in gimmickry with advertised programs to convert economic losses into tax gains by means of an interest deduction. It is difficult to deprecate that motivation for recommending and enacting tax legislation. However, acting on such a motivation without at the

5. Statement of Merrill P. Arden of the Association for Advanced Life Underwriting. *Id.* (Part 3, 1320, 1326).

same time locating and eradicating the root cause of the problem, does not achieve a lasting result. It may put out of action a particular weapon which the taxpayer side is using to harass the government side, but it does not end the battle or stabilize the battle line.

Section 215 of the 1964 Act contained a number of exceptions which will be discussed later. The effective date of this provision was fixed by applying it to interest paid or accrued in years beginning after December 31, 1963, but only to contracts purchased after August 6, 1963 — the date the House Committee first announced its action on the provision.[6]

Except for a later abandoned Senate Finance Committee change in the effective date provision,[7] section 213 of the bill,[8] as it was reported by the Ways and Means Committee, went through the legislative mill without change and emerged as section 215 of the Revenue Act of 1964.

The Treasury recommendations regarding the provision spoke in comparatively broad terms of disallowing an interest deduction in situations where a plan contemplated incurring indebtedness to purchase insurance contracts. However, the provision as enacted is couched in narrow language. The statutory language does not hit at all borrowings to purchase insurance, but only at plans involving borrowings which are parts of plans contemplating the borrowing "of part or all of the increases in the cash value of such [insurance] contract." The narrowing of language between the Treasury proposal and the statute can be explained by the fact that the provision was occasioned by (and aimed at) specific types of plans which are described in the statute. This further demonstrates the approach of neutralizing a particular weapon rather than eradicating a problem.

The Ways and Means Committee Report described the problem by stating that, whereas under the existing law, interest deductions were disallowed in cases of indebtedness in connection with so-called single-premium contracts, "no interest deductions are denied where the taxpayer purchases an insurance contract with the intention of borrowing the maximum amount on the contract each year. . . ."[9] Identical language is in the Report of the Finance Committee.[10]

6. S. Rep. No. 830, Report of the Committee on Finance to accompany H.R. No. 8363, 79.
7. The Senate Finance Committee changed the effective date provision to make the new rule inapplicable to contracts purchased before January 1, 1964, but as finally enacted the original House effective dates were reinstated. *Ibid.*
8. H.R. No. 8363 — which when reported by the Ways and Means Committee was known as the "Revenue Bill of 1963."
9. H.R. Rep. No. 749, 88th Cong., 1st Sess., Report to accompany H.R. No. 8363, 61 (1963).
10. S. Rep. No. 830, 88th Cong., 2d Sess. 77 (1964).

THE FINANCED INSURANCE PLAN

The insurance purchase plans at which section 215 is aimed have been variously described as "financed insurance," "minimum deposit" and "bank loan" plans. An appreciation of the problem at which section 215 is aimed requires an understanding of the basic nature of a commercial life insurance contract.[11] At the risk of oversimplification, the basic nature of a life insurance arrangement can be summarized as follows:

A premium paid on a so-called ordinary life insurance policy consists of three principal elements. The first element is designed to pay the insurance company for its overhead and direct expenses in connection with the issuance and maintenance of the policy. This "loading charge" covers the selling agent's commission and the myriad overhead costs of the company to stay in business — executive salaries, occupancy costs, etc.

The second element in the premium consists of the cost of pure insurance protection for the year of payment. This element, pooled with like elements from other premiums (and supplemented by earnings on policy reserves), enables the insurance company to pay claims for deaths of policy holders which occur during the year.

The third element in the ordinary life policy premium consists of the addition to the policy reserves. This is the fund which is in part the source for cash surrender or loan values. This is also the fund which, during the early life of the policy, represents the "fat" which, during the later life of the policy, can be partially consumed to cover the increasing mortality costs of the policy and which thus permits the leveling of premiums.

In a term insurance plan there is no (or occasionally a minuscule) cash surrender value associated with the contract. This is because the addition to reserve element in the ordinary life premium is omitted, leaving only the pure insurance and loading cost elements in the premium.

Practically all of the income tax problems associated with insurance company contracts have their roots in the very simple fact that in the ordinary case the interest earned on the reserve created under an ordinary life insurance contract is not subjected to income tax.[12]

11. An excellent and more detailed description of the nature of life insurance (with particular emphasis on the problem discussed here) is contained in a paper entitled "Minimum Deposit Plans: A Primer for Life Insurance Counsel" read before The Association of Life Insurance Counsel on May 26, 1959 by Robert W. Smith, Jr., Assistant General Counsel, Union Mutual Life Insurance Company, Portland, Maine, XIV Proceedings of Association of Life Insurance Counsel 575–630, 8 Estate Planners Quarterly, No. 3 (September 1959).

12. Section 101(a) of the Internal Revenue Code of 1954. However, in Gallun v. Comm'r, 327 F.2d 809, 61–1 U.S. Tax Cas. par. 9253 (7th Cir. 1964), *affirming*

As stated earlier, the interest element on reserves created under annuity (as opposed to life insurance) contracts are not destined for tax-free treatment. Under the present day system of taxing annuity payments, the reserve interest element is, in effect, subjected to income tax,[13] albeit such inclusion is deferred until the period of actual payout on the contract or until the sale of the contract.[14]

However, the fact that Code[15] Section 264 now lumps annuity contracts with insurance and endowment contracts indicates that Congress and the Treasury are concerned about something more than the situation in which interest could be deducted and the related interest income never subjected to income tax. If only the last was a matter of concern, there would be no reason for treating a borrowing in connection with an annuity contract the same as a borrowing in connection with a life insurance contract.

THE ANCESTORS OF SECTION 215

The last observation is illustrated by the fact that from time to time Congress has explicitly recognized the distinction between insurance contracts and annuity contracts and reflected its awareness in the statutes. Section 23 of the Revenue Act of 1932 specifically disallowed interest or indebtedness "in connection with the purchasing or carrying of an annuity."[16] No mention was made of interest on borrowing to purchase endowment or life insurance contracts. The pertinent provision was added by the Senate Finance Committee, but surprisingly, there was no mention of the addition in the Finance Committee Report on the bill.[17]

The Finance Committee's addition to the 1932 Act is explained by the same Committee's report on the Revenue Act of 1934 from which the mentioned addition in the Revenue Act of 1932 was deleted. In the report on the 1934 Act the Finance Committee stated:

> The existing law also prohibits the deduction with respect to interest paid or accrued on indebtedness incurred or continued to

T.C. Memo 1963-167, 22 CCH Tax Ct. Mem. 798 (1961), the Court held that the gain on sale of an insurance contract was taxable as ordinary income on the theory that such gain was primarily attributable to the previously untaxed interest buildup on the contract reserve.

13. INT. REV. CODE OF 1954, § 72.

14. First Nat'l Bank v. Comm'r, 309 F.2d 587 (8th Cir. 1962), *affirming* 20 CCH Tax Ct. Mem. 1411 (1961); Roff v. Comm'r, 304 F.2d 450 (3rd Cir. 1962), *affirming* 36 T.C. 818 (1961); Comm'r v. Phillips, 275 F.2d 33 (4th Cir. 1960), *reversing* 30 T.C. 866 (1958), non acq. 1959-1 C.B. 6; and Arnfeld v. United States, 163 F. Supp. 865 (Ct. Cl. 1958), *cert. denied*, 359 U.S. 943 (1959).

15. All references to the "Code" are to the Internal Revenue Code of 1954.

16. 47 Stat. 179 (1932).

17. S. Rep. No. 665, 72d Cong., 1st Sess., 1939-1 CUM. BULL. (Part 2) 496.

> purchase or carry an annuity. The House bill enlarges this prohibition to apply if the proceeds of the indebtedness are actually used in purchasing or carrying an annuity. The theory for not allowing the deduction in such cases is that, since the annuitant was not required to report annuity payments as income (until they exceeded his capital investment), he ought not to be permitted to reduce his taxable income by the allowance of such a deduction. However, since the annuitant is required under the bill to include in income a certain part of the annuity payment received each year, your committee is of the opinion that *the reason for denying the interest deduction in such cases no longer exists.* Accordingly, your committee recommends the omission from the bill of the provision prohibiting the deduction of interest "on indebtedness incurred, or continued, or the proceeds of which were used, in connection with the purchasing or carrying of an annuity."[18] (Emphasis added.)

That statement indicates that in 1932 the pertinent interest deductions were disallowed not because the interest buildup in the annuity contract would under no circumstances be taxable (it would have been at least in part if the annuitant received enough payments to exceed his cost), but rather because such interest *might* under some circumstances not become taxable. The latter would be the case if the annuitant failed to recover his cost basis. Thus the Congressional action in 1932 is consistent with a concern over the timing of the deduction of interest versus the taxation of the interest buildup.

The Revenue Act of 1942 amended section 24(a) of the Internal Revenue Code of 1939 by adding a provision to disallow an interest deduction on indebtedness associated with the purchase of "a single premium life insurance or endowment contract." Loans in connection with annuity contracts were not mentioned. The 1942 change was explained in the Ways and Means Committee report as follows:

> Under the present law, a considerable loop-hole exists through which persons who borrow money to purchase single premium or fully paid up life insurance or endowment contracts secure substantial tax advantages. No income tax is paid with respect to the proceeds of such insurance and in addition the taxpayer may use the interest upon amounts borrowed to purchase or carry such contracts to reduce his other income.[19]

The explanation of the 1942 change indicates a concern with a situation in which the interest buildup on the contract reserve was fully exempt from income tax — as in life insurance or endowment con-

18. S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934), 1939-1 CUM. BULL. (Part 2) 586, 605.
19. H.R. Rep. No. 2333, 77th Cong., 2d Sess. 47, 1942-2 CUM. BULL. 372, 410.

tracts — rather than with the situation in which the taxation of the interest buildup is deferred or somewhat contingent, as in the case of an annuity contract. This represents a shift from the basis of concern indicated in the 1932 legislation concentrating on the timings of the deduction and the inclusion rather than total inclusion or exclusion of the interest buildup.

The deductibility of interest on loans in connection with insurance and annuity plans again became a matter of legislative concern in 1954. In the Ways and Means Committee Report on the bill, which became the Internal Revenue Code of 1954, there is the following statement:

> Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest below the increment in value produced by the annuity.[20]

The plan referred to in the just quoted report was one that had been highly touted and even advertised in the Wall Street Journal. The advertised tax advantages of such plans were based on the assumption that the interest on the policy loans would be presently deductible against ordinary income; whereas, the realization of the interest buildup would be accomplished through a sale resulting in long-term capital gain. Both assumptions proved to be erroneous in most cases.[21] However, these disillusionments did not occur until after Congress had enacted the Internal Revenue Code of 1954 with its provisions to close what then appeared to be a loophole.

Section 264 of the Internal Revenue Code of 1954 extended to annuity contracts the prior provisions which disallow interest on loans connected with purchases of single-premium insurance and endowment contracts. At the time of enactment of the 1954 Code, there were no court decisions flatly disallowing the deduction of interest under plans

20. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 31 (1954). To the same effect see the Finance Committee Report on the same bill, S. Rep. No. 1622, 83d Cong., 2d Sess. 38 (1954).

21. The assumption regarding the deduction of interest was rendered erroneous in most cases (except for a number of fortunate taxpayers who secured private favorable rulings from the Internal Revenue Service) by the Supreme Court's decision in Knetsch v. United States, 364 U.S. 361 (1960), and the assumption regarding capital gains treatment was destroyed by the court decisions cited *supra* note 14.

described in the Committee report or holding gains on sales of annuity contracts to be taxable as ordinary income. Accordingly, one must assume that the situation which concerned Congress sufficiently to warrant extending the applicable provision to annuity contract loans was the situation in which a taxpayer could "trade" a current ordinary deduction for a later capital gain. This represented a reversion to the genesis of the 1932 Act, viz., a concern with the timing of the interest deduction versus the taxation of the interest buildup.

A review of the shifts through the Revenue Acts of 1932, 1934 and 1942 and the original 1954 Code in the provisions regarding disallowance of interest on insurance, endowment and annuity plan loans fails to reveal any wholly consistent and coldly logical rationale which would explain and reconcile all of the various attacks on the problem. The only factors which seem to have been present every time Congress tightened up the rules was an awareness that "somebody is getting away with something" and a feeling that "something ought to be done about it." The history of the legislative actions points up the fact that the Treasury and Congress have neither been disturbed solely by the theoretical possibility of a loss of revenue due to an absence of perfect symmetry in the statutory scheme nor solely by the fact that some taxpayers might be securing a benefit from the lack of symmetry. Rather, the tenor of the various committee reports and hearings associated with the statutory changes reflects a revulsion at the idea that the tax saving aspects of the situations were openly touted. One gets the feeling that the loophole might have gone unclosed (and possibly unnoticed) but for the fact that its existence was widely advertised.

THE PRESENT STATUTE

Code section 264, as amended by section 215 of the Revenue Act of 1964, is set forth in full text in the margin.[22] It contains the present statutory rules regarding the disallowance of deductions for interest on loans associated with insurance, endowment and annuity contract loans.

22. SECTION 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.
(a) GENERAL RULE. — No deduction shall be allowed for—
(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.
(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.
(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all

The statute refers to disallowance of interest on indebtedness "incurred or continued to purchase or carry" a single-premium contract. The breadth of the quoted language was obviously designed to discourage attempts to achieve indirectly what could not be done directly. Thus, the statute cannot be subverted by such devices as purchasing the contract without resort to borrowing and then, soon thereafter, securing a loan to carry the contract. Surprisingly, there have been no reported court decisions directly concerned with questions of interpretation of Code section 264 or its predecessors. The appurtenant Treasury regulations[23] do little more than repeat the language of the statute.

Code section 265(2), having to do with the non-deductability of interest on loans associated with purchasing or carrying tax-free bonds, contains language similar to that in section 264. Due to the similarity of both statutory language in, and basic purposes behind, sections 264 and 265, rulings and decisions interpreting the latter are important in applying the former. The Treasury regulations under section 265,[24] like their counterpart under section 264, do little more than repeat the statute.

In 1922 the Bureau of Internal Revenue published I.T. 1213[25] having to do with the deduction of interest under section 234(a)(2) of the Revenue Act of 1921, which provided for disallowance of interest "incurred or continued to purchase or carry" tax-free bonds. The quoted statutory language is identical with that in Code sections 264

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of the increases in the cash value of such contract (either from the insurer or otherwise).

Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963.

(b) CONTRACTS TREATED AS SINGLE PREMIUM CONTRACTS. — For purposes of subsection (a)(2), a contract shall be treated as a single premium contract—

(1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

(c) EXCEPTIONS. — Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3)—

(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (a)(3) does not exceed $100,

(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or

(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid.

23. Treas. Regs. § 1.264-2 (1953).
24. Treas. Regs. § 1.265-2 (1953).
25. I.T. 1213, I-1 CUM. BULL. 132 (1922).

and 265. There the Bureau held that interest on a debt incurred to pay city taxes was deductible despite the fact that Liberty bonds (the interest on which was presumably tax-free) were pledged to secure the loan. Applying the implicit reasoning of the 1922 published ruling to present day Code, section 264(a)(2) means the Internal Revenue Service should not use that particular paragraph of section 264 to disallow a deduction of interest on a loan secured by a single-premium life insurance, endowment or annuity contract so long as the impetus for the borrowing was other than a plan to purchase the tainted type of contract.

The Tax Court has implicitly accepted the reasoning behind I.T. 1213 in approving deduction of interest on loans secured by tax-free obligations where the obligations were received by taxpayers for sales of goods and services and the purpose of the loans was to secure working capital to be used in the taxpayer's business.[26]

In *Constance M. Bishop,*[27] the taxpayer secured a bank loan, the proceeds of which were originally invested in taxable securities. Over a year later the taxpayer sold some of her taxable securities and reinvested the proceeds in tax exempt securities. During the taxable years involved, the taxpayer continued to hold taxable securities with values equal to nearly 30 times the amount of the questioned loan. During the same period the value of the taxpayer's tax exempt securities amounted to only about 10% of the value of her total securities. Nonetheless, the Tax Court denied a deduction for interest on the loan for the period after purchase of the tax exempt securities and did so by what amounted to a tracing analysis of the disposition of the loan proceeds. The Tax Court treated as insignificant the fact that the tax exempt securities were not pledged to secure the loan.[28]

In Rev. Rul. 55–389[29] the Service held that interest on corporate debentures was deductible where the ultimate purposes of the issuance of the debentures was to raise capital for use in business and that such was the result even though a part of the proceeds of the issuance of debentures was temporarily invested in tax exempt securities.

Taking the net results of the aforementioned cases and rulings and applying them under Code section 264(a)(2), the following con-

26. R. B. George Machinery Co., 26 B.T.A. 594 (1932), *acq.* XI–2 CUM. BULL. 4 (1932), and Sioux Falls Metal Culvert Co., 26 B.T.A. 1324 (1932), *acq.* XII–1 CUM. BULL. 11.

27. 41 T.C. 154 (Oct. 1963) now on appeal to the Sixth Circuit Court of Appeals.

28. Bernard H. Jacobson, 28 T.C. 579 (1957), *acq.* 1957–2 CUM. BULL. 5, contains the same holdings as the *Bishop* case on (1) the lack of significance of the availability of substantial assets other than tax exempt securities or the fact that there is no pledge of the tax exempts and (2) the principle that there should be a "tracing" operation in determining whether loan proceeds are used to purchase or carry tax exempt securities.

29. 1955–1 CUM. BULL. 276.

clusions arise: (1) interest on loans involving insurance and annuity contracts will not be disallowed where the ultimate purpose of the borrowing is to raise funds for business use; (2) if loan proceeds can be traced to a purchase of a contract, the interest will be disallowed regardless of the availability of other funds which could have been used to purchase the contract; (3) the fact that the contract is not used as security for the loan is insignificant[30] and (4) the statute will be narrowly construed to avoid interfering with bona fide business arrangements or construed broadly to prevent a revenue leak, as the occasion demands.

Code section 264(c)(4) (added by section 215 of the 1964 Act) provides that section 264(a)(3) is not applicable if the "indebtedness was incurred in connection with [the taxpayer's] trade or business." The statutory exception is limited to a disallowance occurring under paragraph (a)(3) — that being the paragraph added by the 1964 Act and relating to a loan which is part of a plan which contemplates a systematic borrowing. The section 264(c)(4) exception does not, by its terms, apply to a paragraph (a)(2) situation, viz., a loan involving a single-premium contract. This quirk in the statute may give some basis for an argument that the business use exception developed under Code section 265(2) by rulings[31] and decisions[32] is not available in cases involving borrowings in connection with single-premium contracts, since the statutory exception does not extend to paragraph (a)(2) cases.

There is nothing in the legislative history of section 215 of the 1964 Act which supports such an argument. There is no apparent policy benefit to be achieved by the adoption of the argument. A contrary result is more consonant with the purpose of the statute and can be reached by a reasonable, fair, impartial and practical interpretation of the statute.[33]

In a technical sense, the term "single premium," as used in section 264(a)(2) and (3), is not "defined." The term is used in the operative paragraphs, and subsection (b) merely states that: "For purposes of subsection (a)(2) a contract shall be:

30. The Treasury's proposed regulations under Code section 264 to reflect the 1964 amendments expressly so state. Proposed Treas. Regs. § 1.264-4(c)(2), 29 Fed. Reg. 10470 (1964).

31. I.T. 1213 I-1 CUM. BULL. 132 and Rev. Rul. 55-389, 1955-1 CUM. BULL. 276, both discussed *supra*.

32. R. B. George Machinery Co. and Sioux Falls Metal Culvert Co. cited *supra* n.26.

33. It is thus that the Internal Revenue Service personnel have been ordered to proceed in interpreting the Code. Rev. Proc. 64-22, 1964-22 INT. REV. BULL. 74 (June 1, 1964), originally released as T.I.R. 592 (May 1, 1964). See also Caplin, *The Commissioner's Reply: Reasonable Tax Administration and Current Policies of I.R.S.*, 20 J. TAXATION 110 (February 1964).

treated as a single premium contract —

(1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract. (Emphasis supplied.)

The usual method of introducing a statutory definition is to state that for purposes of the statute a term "shall mean" whatever is then stated.[34] The only significance of the non-definitional aspect of 264(b) is to indicate that merely because a contract falls outside the ambit of section 264(b) does not necessarily mean that it is not a single-premium contract for purposes of subsection (a)(2). For example, if subsection (b) was a true definition section, it would be possible to argue (although this author would hesitate to do so) that if a single premium is paid *before* the date the contract is "purchased," the contract is outside of the language of subsection (b). This would be based on the proposition that being paid before the purchase, it was not paid within four years "from" the date of purchase and, alternatively, being deposited to pay only a single premium, it was not deposited for payment of a "substantial number" of premiums. If any additional ammunition be needed to shoot down such hyper-technical arguments, the non-definitional aspect of subsection (b) should suffice. Accordingly, any contract which in ordinary parlance would be referred to as a single-premium contract is effected by section 264 whether or not it is described in subsection (b).

For some unexplained reason, in the 1964 amendment of section 264 subsection (b) was not amended to provide that the inclusion of described arrangements within the term single-premium contract would be applicable for purposes of both new subsection (a)(3) and old subsection (a)(2). This may have been an oversight or the draftsman may have believed that subsection (b) was made indirectly applicable to paragraph (a)(3) by virtue of the mention in the latter of "a single-premium contract *or a contract treated as a single-premium contract.*" In any event, the legislative history indicates that the committees concerned believed that the single-premium contracts excepted from the operation of paragraph (a)(3) were those which fell within the ambit of paragraph (a)(2).[35]

34. *E.g.*, see Code § 7701.

35. H.R. Rep. No. 749, 88th Cong., 1st Sess. 61, A60, A61 (1963), and S. Rep. No. 830, 88th Cong., 2d Sess. 78 (1964), *supra* n.30, at § 1.264-4(a).

One of the most troublesome interpretative problems posed by section 264(b) is the determination of the meaning of the terms "substantially all the premiums" and a "substantial number of future premiums." Neither the committee reports nor the Treasury regulations give any assistance in dealing with this problem. The Service does not issue rulings on the question.[36] One suspects that the Service's unwillingness to publicly draw a line in this area is to discourage the proliferation of plans which would go right up to the line. With the enactment of section 264(a)(3) in 1964, the search for the magic definition of substantially all or a substantial number becomes less rewarding. This is because there is now a great risk that even if a plan falls on the good side of the substantially all or substantial number line, there is still the threat that the plan will fall afoul paragraph (a)(3).

The 1964 amendments of section 264 introduce myriad new terms which are bound to pose serious (if not insoluble) interpretative problems.

The first new term to be construed is "plan of purchase." Unless a borrowing is part of a plan of purchase, the new provision is not applicable. Is the word "plan" as used in section 264 synonymous with the same word as used in Code section 105(e)(1) (employer sponsored wage continuation plans for disabled employees), in Code section 354 (exchanges pursuant to a plan of reorganization) or in Code section 401 (pension profit sharing and stock bonus plans)? The proposed Treasury Regulations under section 264(a)(3)[37] provide for the use of the common, but singularly unhelpful, rule that a determination of the existence of a "plan [is to] be made on the basis of all the facts and circumstances in each case." The proposed regulations then go on to provide that there will be a presumption of the existence of a plan in any case in which the borrowing is for more than one year. Apparently one swallow does not make a summer, but when one sees a second swallow, he must presume that summer has arrived.

While there will be a number of cases in which there will be genuine doubt as to the existence of a "plan," there will also be many situations in which the arrangement obviously constitutes a "plan." The most obvious case will be the one in which an insurance agent submits to a prospect a "presentation" (complete with tables and columns of pre- and post-tax costs) where borrowings are scheduled for the next several years. The committee reports do not give any guidance in formulating the definition of the term "plan" for purposes of the statute.

36. Rev. Proc. 64-31, § 3.013, 1964-30 INT. REV. BULL. 14, 15 (July 27, 1964).
37. Proposed Treas. Regs., *supra* n.30, § 1.264-4(c).

The next interpretative problem posed by the 1964 amendments stems from the fact that the statute refers to a plan "which contemplates the systematic . . . borrowing." The arguments which will revolve around this particular part of the statute will be similar to those which have revolved (and are continuing to revolve) around the term "with a view to" found in the collapsible corporation provisions — Code section 341(b)(1).

In commenting on the word "systematic" in the new statute, the report of the Ways and Means Committee states:

> . . . Thus it [the new statute] would not apply to disallow a deduction in the case of irregular borrowing against the cash value of a contract. However, the mere fact that the taxpayer does not borrow against the increase in the cash value to pay a premium for a particular year does not preclude the new paragraph 3 from applying if under the facts and circumstances a regular pattern of bottling to pay premiums exists. . . .[38]

This leaves the taxpayer in the perilous position of borrowing against an insurance policy at the risk that a revenue agent may conclude that the facts and circumstances of his particular case are such as to make the borrowing part of a systematic plan. The only sure way to avoid this risk is to bring oneself clearly within one of the exceptions set forth in subsection (c). For this purpose paragraph (1) of subsection (c) is the most pertinent exception providing that the new section shall not apply "if no part of four of the annual premiums due during the seven-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness. . . ." This exception is bound to present very troublesome procedural problems to both the Service and the taxpayers.

Assume that during the year 1964 a taxpayer purchases an insurance contract and immediately borrows the full amount of the first year's cash surrender value. In the taxpayer's 1964 return, filed in April of 1965, he deducts the interest on the policy loan. During the calendar year 1965 the taxpayer makes an additional borrowing against the contract equal to the 1965 increase in cash surrender value and deducts in his 1965 return, filed in April of 1966, the interest paid on such loan during 1965. In June of 1966 a revenue agent audits the taxpayer's 1964 and 1965 returns and challenges the deductibility of the insurance policy loan interest on the basis of Code section 264(a)(3). The taxpayer, in the course of the audit, tells the agent that he fully intends to pay the 1966, 1967, 1968 and 1969 premiums without resort-

38. H.R. Rep. 749, *supra* n.35, at page A61.

ing to further borrowing. The likely reaction of the revenue agent will be to disallow the 1964–1965 interest and to tell the taxpayer that when and if he brings himself within the four-out-of-seven-year exception, he can then file a refund claim. Unfortunately for the taxpayer, it may well be that by the time he has satisfied the four-out-of-seven-years exception, the statute of limitations may have run on the 1964 or 1965 refund.

A comparable procedural problem is mentioned in the Ways and Means Committee report.

> . . . However, if any part of four of the first seven annual premiums is paid under the plan by means of indebtedness and the new paragraph (3) otherwise applies, then any deductions claimed by the taxpayer for interest paid or accrued on the loans incurred to pay these premiums will be disallowed if the taxable years involved are not closed by reason of the statute of limitations or other rule of law. . . .[39]

By pointing up a situation in which the Service may be blocked from asserting a deficiency for a closed year, the Ways and Means Committee has gone a long way towards insuring that careful examining agents will be most diligent in tracking down and questioning the deductibility of insurance policy loan interest in the earliest possible years.

The part of the new law which will probably cause the greatest administrative difficulty is the part which refers to the interdicted plan as one contemplating the borrowing "of part or all of the increases in the cash value of [the] contract. . . ." It is this particular language which is also difficult to reconcile with the stated aim of the new legislation.

The just quoted language of the new provision is perfectly tailored to meet the situation in which a purchaser of a contract enters into a plan in which he intends to borrow on the security of the contract and such borrowing is geared to annual increases in the cash surrender value of his contract. However, the quoted language makes the new provision imperfectly tailored to fit the situation in which the borrowing is not directly geared to increases in cash surrender value. In its report, the Ways and Means Committee stated that the new provision "also is intended to cover cases where the individual borrows on other property or on his general line of credit to pay the premiums. . . ."[40] Thus, the Committee had in mind a situation in which the taxpayer had adequate property or credit which would enable him to borrow without regard to increases in cash surrender value of the contemplated insurance contract. Assume that such a taxpayer is planning to purchase a new ordinary life insurance contract on which the annual

39. *Id.* at A62.
40. *Id.* at 62.

premium is $5,000, but which contract has no cash surrender value during the first policy year and cash surrender values thereafter increasing at the rate of $1,000 per year. There is a serious question whether a borrowing of the entire amount of the premium for the first five years would fall afoul of the new provision. In our hypothetical we are assuming that the taxpayer is able to borrow $5,000 annually and to do so without regard to the value of his insurance contract. Surely during the first year (in which the contract has no cash surrender value) it cannot be said that the taxpayer is participating in a plan which contemplates the borrowing of all or any part of the cash value of the contract — it has none. The answer for the second year is not so easy. During the second year we have assumed that the contract has a cash surrender value of $1,000, but during that year the insured has borrowed five times the cash surrender value. There are at least three ways in which the statute could be interpreted for purposes of application to our hypothetical taxpayer during the second year of the plan. The first way of interpreting the provision is to hold that since the borrowing of $5,000 exceeded the increase in cash surrender value, section 264(a)(3) is not applicable to any extent.

A second interpretation would be to the effect that since the borrowing was at least in part equal to all of the increase in cash surrender value during the second year, the borrowing, therefore, fit the statutory language and no part of the interest deduction on any of the loan — which at that point had reached $10,000 — was deductible. This interpretation requires considerable stretching of the statute and would make the punishment far exceed the gravity of the taxpayer's "crime." Since the basic evil at which Congress took aim involved the deduction of interest against ordinary income without the complimentary inclusion in the tax base of the interest buildup in the reserve, it would seem that the disallowance of the entire amount of the interest on the full $10,000 loan in our hypothetical would go beyond anything Congress could have intended. This is because $9,000 of the borrowed funds with respect to which the taxpayer is paying interest did not add to the reserve against the insurance contract and thus produce tax-free buildup of interest.

A third and "middle-ground" interpretation of the statute, under these circumstances, would be to disallow the interest only to the extent of the $1,000 of loan which matches the second year's cash surrender value increase. This interpretation has the advantage of being consistent with the basic purpose of the statute. However, it, like the interpretation which disallows any interest deduction, requires considerable stretching of the statutory language.

The Treasury in its proposed regulations[41] has announced that its present leaning is towards the position that when the borrowing exceeds the increase in cash surrender value the entire interest payment becomes non-deductible. The proposed regulations contain an example in which there is a cash surrender value but no borrowing during the first year, followed by the increasing cash surrender values and borrowings during the next three years. In the Treasury's example the borrowings after the first year always exceed the cash surrender values. The proposed regulations conclude that no part of the interest is deductible. The proposed regulations do not cover the situation in which there is no cash surrender value to the contract during one or more years. Presumably, the statute does not cover the case of a contract (such as a pure term insurance policy or a newly issued ordinary life contract) which has no cash surrender value. If the last is so, the position taken in the proposed regulations leads to the patently absurd result that, if a contract has no cash value, all of the interest paid on a loan to pay the annual premium will be deductible; whereas, if the policy has one dollar of cash surrender value, none of the interest is deductible.

If Congress is to maintain the basic approach used in Code section 264, the section should be amended to expressly provide the result set forth as the middle-ground interpretation, *i.e.,* disallowance of interest to the extent the loan matches the increase in cash surrender value.

THE EXCEPTIONS

Subsection (c) of section 264 sets forth four exceptional situations in which the disallowance provisions of section 264(a)(3) become inapplicable. The first, already discussed above, is the situation in which no part of four out of the first seven annual premiums on the contract is paid by means of indebtedness. In order to block what the Ways and Means Committee foresaw as a possible dodge to evade the statute through the use of the first exception, there is a special provision to the effect that where there is a substantial increase in the premiums on the contract, a new seven-year period commences on the date of the payment of the first of the increased premiums. This was to forestall the use of a plan under which there would be abnormally low premiums during the first four years of the life of the contract (which presumably the taxpayer could easily handle without resort to borrowings) followed by a substantial increase which would trigger the borrowing plan.

The second exception to the new rule is a *de minimis* provision which provides that the new provision is inapplicable if the total interest

41. Proposed Treas. Regs., *supra* n.30, § 1.264-4(b).

payments during any year, which would otherwise be non-deductible, do not exceed $100. It should be noted that this is not the equivalent of providing that the first $100 of otherwise non-deductible interest is deductible. If the non-deductible interest paid during any year amounts to over $100, then all of the interest — including the first $100 — becomes non-deductible. While this *de minimis* rule will undoubtedly alleviate the problems of many taxpayers, it does not fully remedy a fairly common situation in which a taxpayer puts his life insurance premium payments on what amounts to a monthly budget plan by securing an annual loan from the bank enabling him to pay all of his insurance premiums at one time and to repay the bank in equal monthly installments, which include an interest element. Presumably, if such an arrangement was part of a plan, there would be serious doubt whether the bank interest would be deductible at all or possibly only in part.[42] Such a borrowing plan lacks the tax gimmick aspects at which Congress was aiming. Further, the budget-borrowing plan will directly raise the issue discussed above — whether the new statute applies where the borrowing is equal to the amount of the premiums rather than geared to the increase in cash surrender value. If it is held that such monthly repayment loan plans fall afoul of section 264(a)(3), the effect may well be to force policyholders to accept from insurance companies the usually more expensive plan of paying premiums on a monthly or quarterly basis.

The third exception under the new rule concerns an indebtedness "incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in [taxpayers'] financial obligations." It staggers the imagination to contemplate the number of instances in which taxpayers and revenue agents will differ regarding the applicability of this exception in particular circumstances. The section reflects an admirable concern by Congress to take care of hardship situations in which an ordinary taxpayer must turn to his life insurance as a source of borrowing to handle emergency and unusual situations. The presentation of a few of the situations which may well arise under this exception will be sufficient to point up the unlimited number of problems which it will pose. Assume that the taxpayer is an elevator operator in an office building which the city has announced it will condemn in two years with the announced purpose of demolishing the building so that the site may be used as a municipal parking lot. The elevator operator loses his job when the demolition work begins. Does this situation result in an "unforeseen" loss of income? Does the birth

42. The problem was called to the attention of the Ways and Means Committee by Francis G. Bray, H.R. Doc. No. 43, 88th Cong., 1st Sess., Part 2, 1217, 1219 (1963).

of a child result in "unforeseen" increase in a taxpayer's financial obligations? This last problem may well sharpen and make more critical the issue of population control and planned parenthood. If the problem of whether a birth of a child qualifies a taxpayer for the benefit of the unforeseen financial obligations exception is to be covered in a regulation or a ruling, the Treasury draftsmen must be most careful in stating the basis for the rule in order to avoid converting section 264(c)(3) into a penalty against married parents or a tax subsidy for unmarried parents.

The last exception is with respect to indebtedness "incurred in connection with [the taxpayer's] trade or business." This exception is closely akin to the just-stated exception and is in essence an attempt to ameliorate harshness of the statute in situations in which Congress believed that there was a good faith borrowing, completely dissociated from any plan of tax avoidance. As indicated at an earlier point in the discussion, this exception, for loans incurred for business purposes, is in a sense a codification of a similar rule adopted by the Tax Court and the Internal Revenue Service for purposes of Code section 265(2), relating to interest on obligations incurred to purchase or carry tax exempt bonds.

SPLIT-DOLLAR PLANS

In recent years the so-called split-dollar plan for purchasing life insurance on the lives of employees has become popular. The basic split-dollar plan is relatively simple and involves the purchase of an ordinary life insurance policy with the insured's employer each year paying that part of the annual premium represented by that year's increase in cash surrender value. The balance of the premium is paid by the insured employee. Under the arrangement the proceeds of the policy (whether by virtue of the insured's death or otherwise) are paid to the employer to the extent of the cash surrender value at the time the insurance terminates, and the balance (if any) of the insurance proceeds are paid to the beneficiaries of the employee. Some companies have introduced slight modifications of the basic plan just described, such as provision for leveling of the employee's contribution so as to avoid the situation which arises in a straight split-dollar plan, *i.e.*, the situation of the employee's share of the premium being greatest in the earliest years of the life of contract and then diminishing as the contract matures. This situation is obviously mismatched with the normal progression of the employee's income. The result under the straight split-dollar plan is that the employee pays the maximum amount for insurance coverage at a time when his compensation is at a minimum and the minimum amount of contribution at a time when his compensation is at a maximum.

In Rev. Rul. 55–713[43] the Service ruled that a split-dollar insurance plan of roughly the type just described did not result in any taxable compensation to the insured employee either at the time premiums were paid or when the death benefits were distributed to the employee's beneficiary or estate. The rationale of the ruling was that the arrangement constituted no more than the employer making an interest-free loan to the employee equal to the increase in cash surrender value of the life insurance policy. As pointed in the ruling, ". . . the mere making available of money does not result in realized income to the payee or a deduction to the payor." Although not expressly so stated in the published ruling, another analysis of the split-dollar plan consistent with the result of the ruling is to say that the interest-free loan to the employee might result in a constructive payment of compensation in the form of the value of the interest not collected by the employer, but that if such value was included in the income of the employee, he would be entitled to an offsetting deduction for the constructive payment back to the employer of the interest. This analysis of the transaction is in line with the decision of the Tax Court in *J. Simpson Dean*[44] where the Court held that an interest-free loan from a controlled corporation to its stockholder did not result in taxable income to the stockholder. The Tax Court relied in part upon Rev. Rul. 55–173, *supra,* and additionally reasoned that even if the interest-free loan resulted in income to the borrower in the form of constructive interest paid from the lender to the borrower and in turn repaid by the borrower, the transaction resulted in no net income because of the borrower's ability to deduct the offsetting constructive interest repayment.

Treasury Secretary Dillon in his statement to the Ways and Means Committee,[45] as supplemented by the technical explanation submitted with his statement, urged legislation which would require employees to include in income the current value of life insurance protection provided by their employers through split-dollar insurance arrangements. Congress failed to act directly on this proposal. Nonetheless, the report of the Ways and Means Committee[46] stated that the issues involved in the split-dollar problem and their proper solution "including the possibility of administrative action, are in need of further study by the Treasury Department." A like statement is contained in the Finance

43. 1955-2 CUM. BULL. 23.

44. 35 T.C. 1083 (1961), *gov't appeal to 3rd Cir. dismissed per agreement,* April 16, 1962.

45. H.R. Doc. No. 43, 88th Cong., 1st Sess. (Part 1), 29, 51, 112 (1963).

46. H.R. Rep. No. 749, 88th Cong., 1st Sess. 62 (1963).

Committee report.[47] Thus, the Congressional committees "handed back" to the Treasury the split-dollar insurance problem. As a result of the actions of the Ways and Means and Finance Committees, the Internal Revenue Service has suspended issuance of further rulings in the area of split-dollar insurance plans and is currently restudying the problem.

If the published ruling with respect to split-dollar insurance plans is to be accepted at face value for the proposition that there is no income element in an interest-free loan of money, it then seems clear that there has been no change in the law which would justify revoking or modifying Rev. Rul. 55–713. However, if that ruling is based on a fundamental assumption (although not expressly stated in the ruling) that if constructive income is found in an interest-free loan, there is an offsetting constructive interest deduction which nets no increase in taxable income by virtue of the plan, the enactment of Code section 264(a)(3) by virtue of the 1964 Act constitutes such a change in the law as to cast doubt on the continuing efficacy of Rev. Rul. 55–713. Accepting the proposition that split-dollar insurance plans are interest-free loans which the insured's employer periodically makes him equal to the annual increase in the cash surrender value of the contract, one could anticipate that such a plan would fit squarely within the terms of section 264(a)(3) as a plan contemplating the systematic borrowing of the increases in cash surrender value of the contract. That being so, the constructive income eliminated by a constructive deduction argument is no longer valid. Whereas, before the enactment of section 264(a)(3) there could have been an offsetting deduction for the constructive payment of interest, that is no longer possible under the new provision. In summary, the issue of whether 264(a)(3) has destroyed the basis for Rev. Rul. 55–713 turns on the fundamental question of what was the basis for Rev. Rul. 55–713. It is possible for the service to argue that 264(a)(3) requires a revocation of Rev. Rul. 55–713. However, it should be conceded by the Service that if it takes the position that the new parts of section 264 require the revocation of Rev. Rul. 55–713, the reasons for such result do not appear on the face of the ruling. For that reason it is submitted that, if Rev. Rul. 55–713 is to be revoked, such revocation should be without retroactive effect. This is to say that the change in law represented by section 264(a)(3) is not such a readily apparent change as to require a fully retroactive application of a revocation.

47. S. Rep. No. 830, 88th Cong., 2d Sess. 78 (1963).

WHAT BECOMES OF THE "LOST" DEDUCTIONS

A matter which has received no apparent attention from the architects of Code section 264 and its predecessors is the tax treatment of the disallowed interest deductions and the status of the underlying indebtedness.

In *Chapin v. McGowan*[48] the Court of Appeals for the Second Circuit held that, for purposes of computing gains from the dispositions of endowment contracts, the taxpayer's basis did not include interest payments made after 1942 on loans incurred to purchase the contracts, despite the non-deductibility of such interest. There is every reason to believe that the same result would follow under present law and that interest disallowed under Code section 264 will not increase the basis. This seems to be a most unfair result. At least one of the justifications for the rules of section 264 is that absent such rules, a taxpayer would be able to deduct what amounts to an interest expense coupled with an income tax-free buildup in the policy reserve. If such interest buildup becomes subject to income tax, a failure to allow a tax-free recovery of disallowed interest amounts to a double penalty. Such a result is in effect the taxing of income without permitting an offset of an expense clearly related to that income.

The Tax Court's decision in the *Gerstell* case[49] did not directly involve a section 264 situation, but the decision has considerable significance in section 264 cases. In *Gerstell* the taxpayer engaged in a program involving the purchase of sizable annuity contracts, followed by borrowing of full cash surrender values, prepayment of interest and further borrowings of the increased cash surrender values attributable to the prepayments of interest. The Tax Court found that the plan involved was not distinguishable from that which the Supreme Court had considered in the *Knetsch* case[50] and accordingly held that the interest payments were not deductible because the purported indebtedness was a sham. Disallowance was not based on Code section 264 or its predecessor, but solely on the unreality of the transaction. As an alternative argument the taxpayer in *Gerstell* contended that the out-of-pocket costs of engaging in the plan were deductible as losses. This the Tax Court denied on the ground that the transaction having been undertaken with no prospect of profit other than a tax saving, the loss was not one incurred in a transaction entered into for profit.

48. 271 F.2d 856 (2d Cir. 1959).

49. R. A. Gerstell, T.C. Memo. 1962-181, 21 CCH Tax Ct. Mem. 994, *affirming per cur.*, 319 F.2d 131 (3rd Cir. 1963).

50. Knetsch v. United States, 364 U.S. 361 (1960).

The result in *Gerstell* suggests that in a section 264 case, not only will the interest associated with the purchase be disallowed and not added to the basis, but as an added penalty, any economic loss on a later sale of the contract will not be deductible.

RECOMMENDATIONS

There is a line in an old song: "There is no one with endurance like the man who sells insurance." That fact should be borne in mind in considering the next steps in what is almost certain to be a renewal of hostilities with respect to the deduction of interest on loans associated with purchases of insurance, endowment and annuity contracts. Insurance contracts are usually not "purchased" in the sense that a prospective insured calls on an agent and asks to buy insurance. On the contrary, such contracts are customarily "sold" by agents whose success and compensation is dependent upon their skills in presenting a package which is not only attractive but also fits the needs of the prospect. One way to make a package more attractive is to have as part of it an income tax saving for the purchaser. It is bound to follow as the night the day that insurance agents and their companies will continue to fashion plans which will offer the prospective insured as much of an income tax saving as is possible. The income tax saving inherent in any life insurance purchase plan stems from the basic fact that ordinary insurance contracts in most cases provide an income tax-free buildup of interest against the policy reserve. So long as that condition exists, there will always be available the basic foundation upon which a skillful insurance man can build a plan involving some income tax savings. While statutes such as section 215 of the 1964 Revenue Act may temporarily halt building operations or force remodeling or revamping of plans, they cannot completely block such plans so long as the interest buildup in life insurance contracts remains income tax free.

Additionally, so long as the interest buildup in an insurance contract reserve remains free of income tax, all loophole closing provisions aimed at the disallowance of the deduction of interest associated with such contracts are bound to create complexity and anomalies in the law which are difficult to justify. As pointed out by one of the witnesses at the hearings before the Ways and Means Committee at which the Revenue Act of 1964 was considered:

> In short, it would seem that the Treasury Department does not particularly mind if a taxpayer borrows money to buy his wife a fur coat or a new car or to finance a vacation trip for her and the children, but that it is dead set on penalizing him if he dares to care enough to borrow money to buy a form of property known

as life insurance for the purpose of providing his family even with the necessities after he is gone.[51]

The approach of denying interest deductions to stopper a loophole caused by the failure to include the interest buildup in income also results in a tax penalty on those who do not have capital accumulations sufficient to purchase property such as insurance, while letting those with capital accumulations continue to enjoy the benefit of tax-free income in the form of interest buildup on insurance contracts. This can be demonstrated by assuming the cases of two hypothetical taxpayers. The first is Mr. *A* who has no capital which produces income for him, but who has a job as a corporate executive which pays him $40,000 per year. Mr. *B* has a comparable job which pays him $40,000, but in addition he has $1,000,000 in securities which produce another $40,000 of taxable income for him. Mr. *A*'s $40,000 of income is included in gross income for tax purposes as is Mr. *B*'s $80,000. *A* and *B* both decide to purchase insurance policies on which the annual premium amounts to $10,000. If either *A* or *B* engages in a program of borrowing with a view to utilizing the proceeds of such borrowing to pay the $10,000 annual premium, they will be denied an interest deduction — at least to some extent depending upon the interpretation of section 264(a)(3). However, if Mr. *B* decides to sell $500,000 worth of his securities (that being the amount which therefore had been yielding him $10,000 of his $40,000 annual investment income), he may then use the proceeds of the sale or some part of it to purchase on a prepayment basis the insurance policy which would otherwise cost him $10,000 in annual premiums. By entering into a prepayment plan he will secure the benefit of a discount which in itself represents a form of tax-free interest buildup on the policy. The balance, if any, left after prepaying a substantial number of insurance premiums can then be used by Mr. *B* to invest in tax exempt bonds or can be invested in a security paying no current dividends but promising the prospects of an eventual capital gain disposition. By following this route, Mr. *B* has reduced his taxable income by $10,000 and is proceeding to enjoy the interest-free buildup of reserve on his insurance contract and whatever other form of currently income tax-free investment he hits upon. Unfortunate Mr. *A* has no such route available to him, and he must either pay the $10,000 annual insurance premium out of after-taxed dollars or borrow the funds necessary to carry his insurance program and pay sizable interest charges out of after-taxed dollars. There seems to be no good policy reason for forcing Mr. *A* into such a disadvan-

51. H.R. Rep. *supra* n.45.

tageous position vis-à-vis Mr. *B* — at least not under a system which is touted to be based upon the "ability to pay" concept.

The present system also creates anomalies between investments in insurance contracts and investments in other types of property which furnish the same possibilities for deferral or possibly complete avoidance of income tax. Under present law there is no provision which denies an interest deduction to a man who borrows money to purchase securities which are destined to pay no ordinary income in the immediate future or, perhaps, ever. Thus a person may borrow money to purchase unimproved real property which he intends to hold for later sale at a capital gain or possibly for his heirs to sell without realization of capital gain. The right of such a person to deduct the interest on his loan has to date not been seriously challenged. It is difficult to discover the difference between interest on such a loan and interest on a loan to purchase life insurance, in terms of effect on the revenue or of ability to pay which justifies this distinction.

The recommendation to change the basic system of taxing life insurance to include in taxable income the presently excludable interest buildup on the reserve is respectfully addressed principally to the Congress and the Treasury Department.

The second and concluding recommendation is addressed to life insurance companies and their agents. When you discover (and it is almost certain that you will) a new method of financing life insurance contract purchases, sell it hard as a plan having a bona fide business or family security purpose, but don't advertise it as a tax-saving gimmick. The flouting of a tax gimmick in the faces of the Treasury representatives and the Congressional committee members can only lead to further statutory changes with attendant complications and inequities.